

Best Interest Finding and Determination

For the Sale of

Alaska North Slope Royalty Oil



Alaska Department of  
**NATURAL  
RESOURCES**  
DIVISION OF OIL & GAS

**550 West 7th Avenue, Suite 800  
Anchorage, Alaska 99501-3510**

**December 29, 2003**

## I. Introduction

The Commissioner of the Department of Natural Resources (DNR), on behalf of the State of Alaska, proposes to enter into a six-month contract to sell the state's North Slope royalty oil to Williams Alaska Petroleum Company (Williams). The proposed disposition will provide a continued supply of crude oil to the North Pole refinery after the existing supply contracts expire, enabling uninterrupted operations at the refinery through September 2004.

The proposed disposition is to relieve market conditions for crude oil to meet in-state needs, and is made under the procedures for a non-competitive disposition described in 11 AAC 03.024. Under the terms of this contract the sale price for the royalty oil will exceed the amount the state would have received by taking its royalty oil in-value.

On consideration of the potential economic, environmental, and social impacts, and the various requirements for sale of the state's royalty oil, the Commissioner finds, under AS 38.05.183(a) and (e), that a negotiated six-month contract for the sale of the state's royalty oil to Williams is in the state's best interest.

The following sections of this determination summarize the criteria and considerations underlying the determination that sale of the royalty oil in-kind is in the state's best interest and summarize the terms of the sale contract.

## II. Background

The State of Alaska owns the oil and gas under state-owned land. It has entered into lease agreements with third parties who explore for, develop, and produce oil and gas from these lands. The state receives a royalty of approximately 12.5 percent of the oil and gas produced from these leased lands, which it may take either "in-kind" (RIK) or "in-value" (RIV).<sup>1</sup> When the state takes its oil as RIV, the lessees who produce the oil market the state's share along with their own production and pay the state the value of its share. When the state takes its royalty share of the oil as RIK, it assumes ownership of the oil, and the Commissioner disposes of it through sale procedures designated either "competitive" or "non-competitive" under AS 38.05.183.

The state's contracts with the North Slope producers require the state to nominate the monthly quantity of royalty oil it elects to take in-kind no later than 90 days before the production month for which the nomination is made. Under unit agreements and many of the leases, the state may be required to nominate to take its royalty oil as RIK 180 days before to the production month. Consequently, in order to supply oil under its RIK oil sale contracts, the state must nominate to take its royalty oil as RIK three to six months in advance of the month of delivery.

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<sup>1</sup> This amounts to about 85 percent of the projected 2003 royalty oil production at the Prudhoe Bay Unit (PBU) based on the "maximum quantity" terms allowed under these two contracts. The state does not sell RIK oil to any other customers although it has also sold RIK oil to various purchasers in the past.

**A. Williams' Current RIK Oil Contracts for the North Pole Refinery Are Due To Expire Before a New Long-term Contract is Negotiated**

The state currently sells RIK oil to Williams under two long-term contracts. The first contract was awarded in 1978 to Williams' predecessor, Earth Resources, Inc. It has a 25-year term under which the state delivers approximately 35,000 barrels per day to Williams' North Pole refinery. Williams also receives about 22,800 barrels per day of RIK oil under a five-year contract awarded in 1998. Both of these contracts expire on December 31, 2003.

Because Williams' Alaska assets, including the North Pole refinery and its retail convenience stores, are up for sale, the state has not negotiated a long-term contract with Williams to continue delivery of RIK oil to the refinery after the existing contracts expire. Instead, the state entered into a short-term contract in October 2003, to continue to supply Williams with RIK oil for the North Pole refinery from January through March 2004, after the two existing long-term contracts expired. The October 2003 contract extended only through March 2004 because the parties anticipated that the North Pole refinery sale would be concluded in time for the state to negotiate a new long-term RIK contract with William's successor in time to make the 90-day advance nominations for crude oil deliveries for beginning in April.

The sale of Williams' Alaska property to Flint Hills Resources, Inc. (FHR), a subsidiary of Koch Industries, Inc., has been negotiated but not yet completed, and may not be finalized until after March 2004. When the sale is completed, FHR will take over the operation of the North Pole refinery and contract with the state for a supply of RIK oil. The state is negotiating with FHR for a long-term RIK oil contract for the refinery after FHR assumes ownership.

At present, without conclusion of the refinery sale, it is not possible to complete negotiations and have a long-term contract RIK oil sale contract in place before the state must make its 90-day advance nomination of RIK oil for delivery to the refinery in April 2004, after the existing short-term contract expires at the end of March. Even after the long-term contract negotiations are concluded, the RIK oil contract will not become effective until DNR provides public notice of findings on the proposed contract terms, convenes the Alaska Royalty Oil and Gas Development Board to review the contract (11 AAC 03.020), and depending on the term of the contract with FHR, seeks approval of the Legislature.<sup>2</sup>

The state anticipated when it entered into the first short-term contract with Williams in October 2003 that the refinery sale and a long-term RIK oil contract would be concluded by January 1, 2003. The process has taken longer, however, and additional time is required to conclude the long-term contract negotiations and comply with the RIK oil sale procedures. The Commissioner therefore finds it necessary for the state to enter

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<sup>2</sup> Legislative approval is required under AS 38.06.055 for sales contracts whose terms are more than one year. Although the state has not completed its negotiations with FHR, the parties are contemplating a one-year contract with an extension subject to approval of the Legislature.

into a second short-term contract with Williams in order to assure a flow of RIK oil to the North Pole refinery after March 2004 so operations will continue without interrupting production.

The state anticipates at this time that the refinery sale will be concluded and a long-term RIK contract will be in effect within the term of this contract. After William's refinery sale is completed, the oil nominated under the long-term RIK will be assigned to Williams' successor.

## **B. RIK Oil Sale Procedure**

The Commissioner establishes the terms, conditions, and methods of disposition of the state's royalty oil that is taken in-kind. The oil may be sold under "competitive" or "non-competitive" procedures depending on the circumstances. Before executing a contract for the disposition of royalty oil in-kind, the Commissioner must find that the disposition is in the best interests of the state.

Before disposing of RIK oil under the "non-competitive" procedures, the Commissioner must conclude that the best interest of the state will be served by a non-competitive sale. (AS 38.05.183(a)) In making this determination, the Commissioner must consider the criteria listed in AS 38.05.183(e) and AS 38.06.070(a). Under these procedures, the RIK oil sale must be awarded to the prospective buyer whose proposal offers maximum benefits to the citizens of the state. (AS 38.05.183(e))

As required by AS 38.05.183(e), the Commissioner considered: (1) the cash value offered; (2) the projected effects of the sale, exchange or other disposal on the economy of the state; (3) the projected benefits of refining or processing the oil or gas in the state; (4) the ability of the prospective buyer to provide refined products or by-products for distribution and sale in the state with price or supply benefits to the citizens of the state; and (5) the criteria listed in AS 38.06.070(a), which are also considered by the Royalty Board in its review of the sale.

Under AS 38.06.070(a), the Commissioner considered: (1) the revenue needs and fiscal condition of the state; (2) the local and regional requirements for petroleum products; (3) the desirability of localized capital investment, increased payroll, and secondary development effects; (4) the social impacts of the sale; (5) the additional costs to the state and local governments caused by the development related to the transaction; (6) the local and regional labor market; (7) environmental effects; and (8) the impact on existing private commercial enterprises and investment patterns.

The Commissioner determined that the continued sale of RIK oil to Williams would relieve market conditions by providing crude oil for uninterrupted production from the North Pole refinery. In addition, the state would benefit from a sale price throughout the term of the six-month contract that would be higher than the volume-weighted average of the reported netback prices applicable to royalty oil taken in-value for the same period. The Commissioner concluded, on balance, that entering into a six-month

contract, from April through September 2004, to sell RIK oil to Williams for continued operations at the North Pole refinery is in the best interests of the state.

This Best Interest Finding and Determination and a copy of the short-term RIK contract are available from the state by contacting:

Division of Oil and Gas  
Attn: Kevin Banks  
550 W. 7th Ave, Suite 800  
Anchorage, Alaska 99501  
Phone: (907) 269-8781  
E-mail: [krb@dnr.state.ak.us](mailto:krb@dnr.state.ak.us)

This Best Interest Finding and Determination and the short-term RIK contract will also be published on the Division of Oil and Gas website at:

<http://www.dog.dnr.state.ak.us/oil/>

A copy of the proposed six-month RIK oil sale contract is attached as an appendix to this Best Interest Finding and Determination.

### III. Discussion Contract Provisions

This six-month RIK oil sale contract between the state and Williams is similar to the October 2003 short-term contract incorporates by reference the terms and conditions of the 1998 RIK oil sale contract titled “Agreement for the Sale and Purchase of State Royalty Oil to MAPCO Alaska Petroleum, Inc.” (“1998 Contract”). Except for the terms discussed below, the Best Interest Finding for the 1998 Contract describes the terms and conditions that are unchanged in this contract.<sup>3</sup>

The essential terms of this contract that differ from the 1998 Contract are summarized below. The differences between the October 2003 short-term contract and this contract are also noted.

#### A. Contract Paragraphs 4 and 5 — Term and Assignment

As stated above, this short-term RIK contract is intended to provide for the uninterrupted RIK oil deliveries to the North Pole refinery until conclusion of the sale of the North Pole refinery to FHR, and a new long-term RIK oil sale contract between the state and FHR. This six-month RIK oil sale contract will enable the state to continue an uninterrupted supply of oil to the North Pole refinery from April through September 2004.

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<sup>3</sup> Alaska Department of Natural Resources, Division of Oil and Gas, March 5, 1998, “Final Finding and Determination to Sell Royalty Oil to MAPCO Alaska Petroleum Inc.” Copies of this document are available at the contacts listed above, including the Division of Oil and Gas website.

The requirements of the leases, unit agreements, and royalty settlement agreements between the state and the Alaska North Slope (“ANS”) producers require the state to nominate royalty oil it intends to take in-kind at least ninety-days prior to the production month in which it will take the RIK oil. This means that by the state must provide notice to the producers no later than January 2, 2004 that it intends to take its royalty oil in-kind for sale to the North Pole refinery in April.

Unlike the 1998 Contract, which obligates the State to nominate royalty oil only from the Prudhoe Bay Unit (“PBU”), the proposed six-month contract provides that the State may supplement its supply of royalty oil from the PBU by nominating royalty oil from other ANS production units. Initially under this six-month contract the state intends to provide 90 days notice to nominate royalty oil from the PBU and 90 days notice to supplement the supply from the North Star Unit. The state may also nominate to take its royalty oil in-kind from other ANS production units under this contract.

Under this contract Williams will be obligated in April 2004 to take the RIK oil that the state nominates for delivery to the refinery. If FHR takes over the refinery on March 1, 2004, as currently planned, FHR will take the RIK oil the state has nominated under this contract for delivery to Williams.<sup>4</sup> Paragraph 5 allows the commissioner of DNR to release Williams of its obligation to take RIK oil after March if FHR agrees to accept the oil nominated under this contract. The state anticipates having long-term contracts with FHR in place by June 2004 for RIK oil deliveries under this contract.

#### **B. Paragraph 6 — Sale Oil Quantity**

The quantity of RIK oil to be nominated each month, as defined in paragraph 6, differs from the provisions in the 1998 Contract. The 1998 contract defined the quantity of RIK oil as a percentage of total royalty oil received by the state at the PBU. Under this RIK sale contract, paragraph 6 is intended to meet the supply requirements that both Williams’ 1978 and 1998 contracts currently provide. The “Sale Oil Quantity” is defined as a barrels-per-day amount averaged for each production month. The per-day barrel amount is bracketed by a high of 77,000 barrels per day and a low of 56,000 barrels per day. Williams has already indicated that it would like the state to nominate 77,000 barrels per day for April delivery. The six-month RIK contract includes an example of how the state converts Williams’ barrel-per-day request to a nomination notice submitted to the lessees according to the provisions in the various agreements between the state and the PBU lessees.

#### **C. Price**

This six-month RIK contract incorporates the price provision of the 1998 Contract (Article 2.3). Williams will be required to pay a premium of \$0.15 per barrel over the volume-weighted average of the payments received by the state from the lessees for the royalty oil in-value. When a new long-term contract is negotiated with Williams’

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<sup>4</sup> Although the discussion in this finding assumes that FHR will buy Williams’ North Pole refinery, the obligation to take RIK delivered under this contract will be the responsibility of whomever owns the refinery in April 2004.

successor in ownership of the refinery, the successor will take the royalty oil nominated under this RIK contract, however, the price term of the new long-term contract between the state and the successor will apply.

#### **D. Other Notable Provisions Incorporated from the 1998 Contract**

**1. Local Hire:** Williams agreed in the 1998 Contract to employ Alaska residents and companies to the extent they are available, willing, and qualified for the applicable work (Article XXII). This provision applies to the six-month RIK contract.

**2. In-state Processing:** Williams agreed in the 1998 Contract to process 80 percent of the RIK oil at the North Pole refinery (Article III). The in-state processing clause assures that the state will enjoy the benefits described in Section IV below. This provision applies to the six-month RIK contract.

**3. Security:** Williams must provide the state an irrevocable stand-by letter of credit. The letter is to be issued for the benefit of the state by a state or national banking institution of the United States that is insured by the Federal Deposit Insurance Corporation and has an aggregate capital and surplus amount of not less than \$100,000,000. The principal face amount of the letter is to be an amount reasonably estimated by the commissioner to be equal to the price of all oil to be delivered by the state during the 75 days immediately following the date of first delivery. The state is to have the right to draw on the letter of credit 75 days after the date of the state's last delivery of RIK oil (Article XVI). This provision applies to the six-month RIK contract.

### **IV. Analysis of State Benefits**

The following analysis appeared in the finding and determination that accompanied the October 2003 short-term RIK oil sale contract between the state and Williams. Insofar as the analysis is applicable to the six-month RIK oil sale contract it is incorporated in this finding with the updated information discussed below.

#### **A. Economic Impacts**

Economic impacts of the RIK sale include the following:

- If Williams continues to operate the North Pole refinery during April through September 2004, all of the RIK oil delivered to Williams under this six-month RIK contract will be priced at a premium of \$0.15 per barrel over the price received by the state for its royalty oil when taken in-value. This could amount to additional royalty revenues of \$1,545,600 to \$2,125,200 depending on how much oil Williams nominates over the next six months.<sup>5</sup>

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<sup>5</sup> The ultimate revenue impact depends on how much RIK oil Williams nominates under the six-month RIK contract during the next three months.

The two long-term RIK oil sale contracts now in effect with Williams will expire on December 31, 2003. If, hypothetically, the long-term contracts were still in effect, without changes to their price and quantity terms, only 40 percent of the RIK oil delivered to Williams in a six-month period would obtain a \$0.15 per barrel premium. Under this six-month RIK oil sale contract, however, the \$0.15 per barrel premium price would apply to all of the RIK oil delivered resulting in \$930,000 and \$1,275,000 more revenue to the state over the same six-month period.

If FHR buys the refinery as expected before this six-month RIK oil sale contract with Williams expires, any RIK oil the refinery receives pursuant to a nomination under this contract will be priced according to the price terms of the long-term contract the state is currently negotiating with FHR to be effective once the refinery sale is concluded.

- Williams employs 545 Alaska residents to operate its refining, marketing, and distribution facilities in North Pole and Anchorage and its 29 convenience stores throughout Alaska. Williams total annual payroll is \$22 million.<sup>6</sup> The North Pole refinery employs 150 residents of the Fairbanks area. It is in the state's interest to ensure that the North Pole refinery continues to receive sufficient royalty oil to operate without interruption.
- Williams provides additional revenue to the state as the largest customer of the Alaska Railroad, accounting for \$34.7 million in freight payments in 2002.
- The North Pole refinery produces nearly 60 percent of the jet fuel sold in Alaska and represents a key element in the state's thriving cargo and passenger air transportation sector, both in Anchorage and Fairbanks.

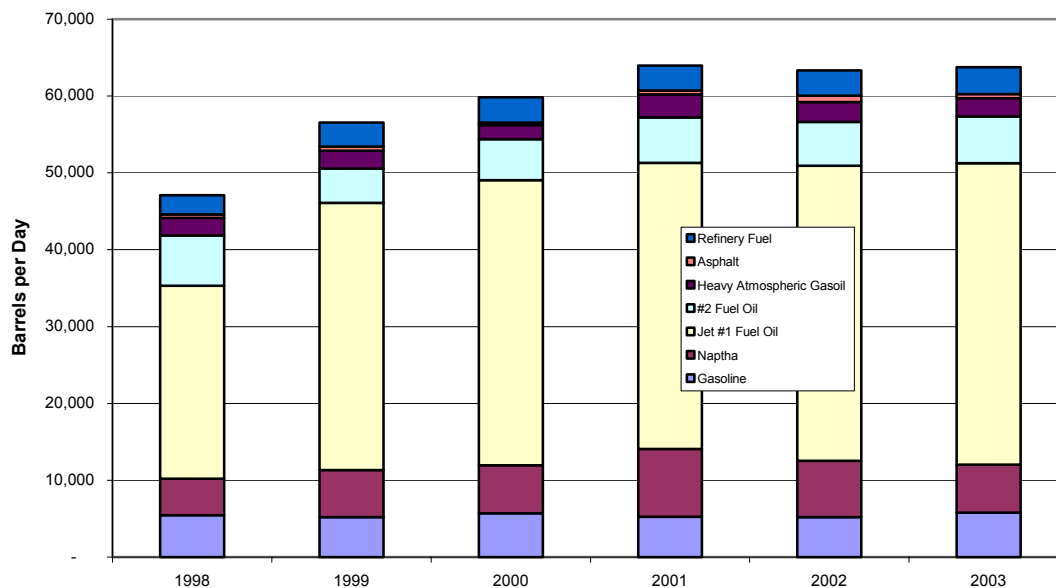
A summary of Williams' North Pole refinery production is illustrated below:<sup>7</sup>

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<sup>6</sup> Williams Alaska Petroleum, Inc. March 5, 2003. "Williams Alaska 2002 Fact Sheet"

<sup>7</sup> Keith Selby, Williams Alaska Petroleum, Inc. March 5, 2003. Personal Communication.

## Refinery Product Retention



### B. Social Impacts

Social impacts of the RIK oil sale include the following:

- Williams North Pole refinery pays \$2.9 million in property taxes to the Fairbanks North Star Borough. Williams' terminal facilities generate annual property taxes revenues of \$168,000 to Anchorage and \$10,500 to Fairbanks.
- No incremental effects on land use, impacts on the local social infrastructure, i.e., schools, public safety, roads, and other government services are anticipated as a result of this RIK oil sale, which continues normal and longstanding business practices.

### C. Environmental Impacts

- No incremental environmental impacts are anticipated as a result of this RIK oil sale, which continues normal and longstanding business practices.

## **V. Findings and Determination**

### **A. Disposal of the Royalty Oil In-kind is in the State's Best Interest**

In accordance with AS 38.05.182, the Commissioner determines that it is in the best interest of the state to take its royalty oil in-kind to provide necessary crude oil supplies to the North Pole refinery.

### **B. Competitive Bidding is Waived**

The Commissioner of the Department of Natural Resources, determines in accordance with AS 38.05.183(a) and 11 AAC 03.030 that the best interest of the state will be served by sale of its royalty oil in-kind to Williams under non-competitive procedures to relieve market conditions. The sale will promote the interest of the state through increased revenues and by facilitating uninterrupted operation of the North Pole refinery.

In deciding to sell RIK oil to Williams under a six-month contract the Commissioner considered that without the contract the State will receive less revenue because its royalty oil will be taken in-value without the \$0.15 premium payment. In addition without the sale Williams will be forced to seek alternative crude oil supplies from ANS producers April 2004 in order to continue operating the North Pole refinery, and there is some risk that a sufficient alternative supply may not be available under such short-term sale circumstances.

A copy of this Finding and Determination is being delivered to the Alaska Royalty Oil and Gas Development Board as notification under 11 AAC 03.040 that the Commissioner has determined that the best interest of the state does not require competitive bidding in this circumstance.

### **C. The RIK Oil Sale Will Relieve Market Conditions**

A non-competitive sale is permitted to relieve market conditions. The regulations, at 11 AAC 03.024, state that a sale of RIK oil to relieve "market conditions" when one of four conditions is met. This six-month contract for sale of RIK oil to Williams relieves market conditions as provided in 11 AAC 03.024:

- (1) in a noncompetitive disposition of royalty oil, gas, or associated substances the commissioner estimates that the sale price throughout the term of the disposition will be higher than the volume-weighted average of the current reported netback prices filed by the lessees for royalty purposes for those filing periods applicable to the term of the disposition; and

(3) the royalty oil, gas, or associated substances disposed of will be used to meet in-state needs for crude oil, gas, or associated substances or petroleum products and the sale price of that royalty oil, gas, or associated substances is at least equal to the in-value amount which would have been received by the state during the same period.

The six-month RIK oil sale under this contract will relieve market conditions because it will provide needed crude oil supplies to the North Pole refinery and the price for oil delivered throughout the term of the contract will exceed by \$0.15 the per barrel the volume-weighted average of the netback prices reported by the lessees in the PBU for royalty purposes.

#### **D. The Proposed RIK Oil Sale Offers Maximum Benefits to the State**

Under AS 38.05.183(e), when RIK oil is disposed of by other than non-competitive bid, the Commissioner must award the disposal to the prospective buyer whose proposal offers the maximum benefits to the state. In making the award the Commissioner must consider the criteria set out in AS 38.05.183(e). The Commissioner must state which of the criteria apply to the proposed disposition, and discuss the weight given to the applicable criteria in determining the maximum benefit to the state. (11 AAC 03.060(b))

In respect to this proposed six-month RIK oil sale to Williams, as discussed below, all of the criteria were found to apply to some extent. Specific weights were not assigned to the individual criteria.

**1. The cash value offered:** The RIK price offered under the proposed contract will during the term of this contract exceed RIV by \$0.15 per barrel. If Williams is still operating the refinery during April through September 2004, the premium above the royalty value of RIV could range from \$1,545,600 to \$2,125,200 depending on how much oil Williams nominates over the next six months.

**2. The projected effects of the sale, exchange or other disposal on the economy of the state:** The sale of RIK oil will increase royalty revenue to the state treasury, and hence the economy of the state, as discussed in paragraph 1.

**3. The projected benefits of refining or processing the oil or gas in the state:** Through incorporating the in-state processing provision of the 1998 Contract in this six-month RIK oil sale contract, Williams continues to be obligated to process the RIK oil at the North Pole refinery. With uninterrupted operation of refinery assured by this six-month RIK contract, Williams will continue to employ Alaska residents, pay wages, purchase supplies and services from Alaskan companies, and pay local property taxes.

**4. The ability of Williams and a prospective buyer to provide refined products for distribution and sale in the state with price or supply benefits to the**

**citizens of the state:** The North Pole refinery has been operating since 1978, and has been operated by Williams since 1998. Under this contract, RIK oil will continue to be processed at the refinery to supply Alaska with petroleum products.

#### **5. The criteria listed in AS 38.060.070(a):**

Criteria (1), the revenue needs and fiscal condition of the state: The state budget gap (the difference between unrestricted general fund revenues and general fund appropriations) is expected to rise from \$0.46 billion in FY 2004 to \$1.07 billion in 2010. Despite fairly level oil production through 2010, the oil and gas sector's contribution to general fund revenue is expected to decline from 84 percent in FY 2004 to 78 percent in 2010 due to increasing production from new, lower-netback-value fields and a lower effective tax rate under the Economic Limit Factor.<sup>8</sup> The sale of RIK oil to Williams at premium over RIV will benefit the state by increased revenues.

Criteria (2), the local and regional requirements for petroleum products: During the term of this contract the North Pole refinery will continue to supply the state with products in roughly the same proportion shown in the chart in Section VI above.

Criteria (3), the desirability of localized capital investment, increased payroll, and secondary development effects: The continued operation of the Williams refinery and its retail and marketing operations provide a significant impact on the local economy of the Fairbanks North Star Borough. In the Findings that accompanied the 1998 Contract, Williams was credited with supporting indirect jobs equal to 2.5 times the direct jobs it provided. Assuming that Williams has 150 full-time jobs at the North Pole refinery, another 375 jobs are generated indirectly in the surrounding regional economy.

See Appendix B for a general discussion of localized capital investment, increased payroll, and secondary development effects of the petroleum industry in the Fairbanks North Star Borough economy.

Criteria (4), the social impacts of the sale: The sale by itself will have no incremental social impacts. If there were no RIK contract executed to supply crude oil to the refinery after March 2004, however, operations at the refinery might be suspended or cut back with possibly serious social consequences caused by worker lay-offs and fuel product supply disruptions.

Criteria (5), the additional costs to the state and local governments caused by the development related to the transaction: There should be no additional costs to the state or local government as a consequence of this sale. In general, petroleum industry industrial activities like the North Pole refinery pay their way with respect to the pressure industry employees place on the local social

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<sup>8</sup> Alaska Department of Revenue. 2003. Spring 2003 Revenue Sources Book.

infrastructure through property and sales taxes paid by both the operation and its employees.

See Appendix B for further discussion concerning costs to the state and local governments caused by development related to the RIK oil sale.

Criteria (6), the local and regional labor market: As indicated above, continued operation of the North Pole refinery will generate as many as 525 direct, indirect, and induced jobs in the Fairbanks area. (AS 38.06.070(a)(6))

Criteria (7), environmental effects: The sale by itself will have no incremental environmental effect.

Criteria (8), impact on existing private commercial enterprises and investment patterns: The Williams' operation in Alaska competes with the other major in-state refineries and the petroleum product market. Insofar as this short-term RIK contract will keep the North Pole refinery in operation, no change in the petroleum refining and marketing industry structure is anticipated.

#### **E. Alaska Royalty Oil and Gas Development Board**

This finding and determination is being submitted to the Royalty Board in compliance with AS 38.05.183(c) and 11 AAC 03.024 and 11 AAC 03.040, which provides that the Commissioner may not waive competitive bidding of an RIK sale unless written notice is given to the board.

#### **F. Legislative Approval**

Legislative approval is not required for RIK oil dispositions with a term of one year or less. (AS 38.05.183)

### **VI. Conclusion**

On careful consideration of the circumstances of the proposed sale, material information and legal requirements, the Commissioner determines, in accordance with AS 38.05.183, that the best interest of the state does not require this RIK oil sale to be made by competitive bid, and that a six-month contract for the sale of RIK oil to Williams offers maximum benefits to its citizens.

<Signed>

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Thomas E. Irwin  
Commissioner

December 29, 2003

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Date

## **Appendix A**

### **Contract**

## **Appendix B**

### **Economic Impacts of the Petroleum Industry on the Fairbanks North Star Borough**

**by**

**Information Insights and the McDowell Group**

Contact Division of Oil and Gas for a copy of this study.